Farm Business Corporations in British Columbia

Second Edition - July, 1983

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FARM BUSINESS CORPORATIONS IN BRITISH COLUMBIA

SECOND EDITION - JULY, 1983

A study prepared for the British Columbia Ministry of Agriculture and Food, Economics Branch.

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Preface

The three most common types of business organization for British Columbia farms are sole proprietorships, partnerships and corporations, commonly known as "limited companies". Each of these organizational forms has advantages and disadvantages depending on the circumstances in which they are used. They also have different legal, operational and tax requirements. Increased capitalization, larger debt loads and higher levels of income and expenses have increased interest in financial management and have encouraged farmers to devote greater attention to the alternative business organizational structures.

In 1978, the use of corporations was made more attractive when the federal government changed the income tax rules applying to the transfer of shares of a farm corporation from one generation to the next. In 1981 however, the corporation became less attractive when the government announced the introduction of a new tax on certain dividends paid by small business corporations.

This publication has been prepared to provide farm managers and farm business advisors with information on farm companies, the advantages and disadvantages of using them and the manner in which they are created. It was originally prepared by Mr. W.A. Barclay, C.A. under a project funded by the British Columbia Ministry of Agriculture and Food "Demonstration of Agricultural Technology and Economics" program (DATE).

This updated edition by Derek J. Pryer, C.A., a partner in the firm of McKnight, Johnson and Partners is in response to continued requests for this type of information and is based on the law following passage of Bill C-139 on March 31, 1983. A memorandum on the April 19th, 1983 Budget, prepared by the Honourable Marc Lalonde, is also included. (see Appendix page 27.)

This two-part publication provides general information on farm incorporation in British Columbia. The first part is entitled, "Twenty Questions About Farm Incorporation" and consists of a series of questions and answers outlining the basic criteria that a farmer should examine. The second part is entitled, "How to Go About Incorporating The Family Farm" and outlines a number of steps which the farmer should consider.

When determining the most appropriate farm business organization, it must be remembered that each situation is unique. The decision requires a careful investigation and evaluation of the type and value of the assets, debts, yearly income, family situation and long-term estate planning goals.

While this publication provides answers to many questions which should be asked and analyzed prior to incorporating the farm business, the advice of farm management advisors, accountants and a lawyer should be obtained before selecting the final course of action.

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INTRODUCTION

One of the most common questions which farm managers ask their professional advisors (including accountants, lawyers, bankers and Regional Farm Economists) is whether or not they should "incorporate" their farming businesses. The answer which the farm manager receives to this seemingly simple question is not always a satisfactory one. In fact, it has been our experience that conflicting advice is often given on this matter. The reasons for this can usually be traced to a failure to explore all of the implications of incorporating a family farm in the light of each farm manager's personal circumstances and financial goals.

In this publication we will review the use of corporations in some detail so that readers can refer to the booklet as a guide in their decision-making. We have attempted to deal with the subject in a way which will be especially meaningful to the farm manager and his advisors. While our coverage of the topic will not be totally exhaustive, we feel that the majority of the major issues involved in making this all-important decision have been considered.

Before going any further, there are two definite statements that we can make about the incorporation of a family farming operation:

a) A farm manager should never incorporate a farming business without a thorough understanding of all of the different implications (income tax and otherwise) of using a corporation to own and operate the farm. (Just because your neighbour has a farm corporation doesn't mean it's best for you too.)

b) On the other hand, a farm manager should never dismiss the idea of incorporation before looking into all of the ways in which the corporate form of business organization could be advantageous to him.

If you have read this far you will realize that, no matter what you are going to do (incorporate or not incorporate), you have no choice but to continue reading!

The first portion of this booklet (Part I) has been written as a series of twenty common questions relating to the pro's and con's of farm incorporation, together with some brief answers and discussion.

If, after reading through this dialogue, the use of a farm corporation is attractive to you, you may wish to refer to Part II of the booklet which outlines steps that can be taken to set up a corporation for your farm.

It is our hope that all readers of the booklet will gain a more thorough appreciation of the complexity of this important decision which has to be faced by all farm managers. More important, we hope that many farm managers will recognize some major financial opportunities that are available to them through the well-planned use of a family farm corporation.

PART I

TWENTY QUESTIONS ABOUT FARM INCORPORATION

1. Size of Operations and Level of Income

Question:

How big a farming operation must I have, or how much income should I be earning each year, to make incorporation worthwhile? In reviewing my past records I have noticed that some years have been quite good while others have shown losses for tax purposes. Wouldn't I have to have a high level of income, which is consistent from year to year to make the use of a corporation pay for itself?

Answer:

There is no precise size for a farming operation, or any specific level of farm income, at which the use of a corporation becomes advantageous. The size of operations is an extremely important factor, however, particularly since the introduction in 1983 of a new tax on certain dividends paid by farm corporations. (This is discussed under the heading "Income Tax Savings and Deferrals" on page 5). As a general rule only those farms which are viable economic units and which generate an income that is in excess of the amount required to meet the living costs of the farmer and his family should be incorporated. If the farm manager and his family need everything that the farm produces in order to live, then they should probably not incorporate. At the other end of the scale, for those larger and consistently profitable farming operations, the use of a corporation may be advantageous. A farm owner who is presently generating consistently a net taxable income from the business which is at least $15,000 - $20,000 a year higher than the amount that he, his spouse and his dependants need to live on should, in our opinion, consider the merits of incorporation.

2. Day to Day Farming Operations

Question:

If I incorporate my farm, will the day to day methods of carrying on my business have to change? I have been used to doing things in a certain way over the years. I don't want to complicate my life with a lot of extra paperwork and unfamiliar legal or accounting jargon that I don't understand - even if it does save me a few dollars in taxes.

Answer:

The day to day way in which the farm operations are carried on would not change much, if at all, as a result of the incorporation of the business. Instead of being the "owner-manager" of a farm, the farmer

will then be a "shareholder-manager" of a farm corporation. All business transactions would then be conducted in the legal name of the corporation rather than in the farmer's own name, but this usually doesn't create any serious problems. Notification would be given to suppliers, customers, government agencies, etc. that they are now dealing with a limited company rather than an unincorporated farm. The company must also maintain a separate bank account which is kept distinct from the personal financial dealings of the individual farmer. Many farmers who operate proprietorships and partnerships are already familiar with the important concept of separating the business dealings of the farm from their personal financial affairs, so the additional step of incorporating the farm usually doesn't cause too many accounting difficulties for them.

The all-important factor to keep mind is that a separate legal entity is created when the corporation is established and commences to operate the farm. Instead of owning and operating the farm directly, the farm manager will own it indirectly through owning part or all of the shares of the company.

3. Control of the Farm

Question:

Can I continue to be completely in charge of the farm operations even though I might allow other people to own some of the shares of the company? Specifically, can I let my children own some of the shares without having to give them any voice in how I run things?

Answer:

Yes. Corporations permit a great degree of flexibility as to how control of a business is maintained, shared, or transferred. It is a relatively simple matter to set up a corporation in a way which permits the owner-manager to have full control of the farm (for the rest of his life if he so desires) while at the same time allowing other family members to participate in the growth in the value of the farm business. Such arrangements are usually made at the time the company is incorporated, by means of the types of shares that are issued by the company. Ownership of a majority of the voting rights (51%) will result in "control" of the company. It would not be unusual, for example, for a father to keep all of the "voting" shares of the company for himself and allow his children to acquire "non-voting" shares. At the time of his retirement from active participation in the farm, the father would transfer his voting shares to his children if he so desired. Alternatively, the children could have a voice in the management of the company through ownership of a few voting shares but be subject to the final authority of the parents who would retain a majority of the voting shares. In summary, the structure of the voting rights of the company's shares can be set up to reflect the parental authority and ultimate decision making which already exists in a natural way in the operation of many unincorporated family farming businesses. No control or authority need be lost or given away as a result of incorporation.

4. Income Tax Savings and Deferrals

Question:

Will the use of a farm corporation reduce the amount of income taxes that I have to pay each year? Don't I really pay just as much tax in the long run?

Answer:

In the past, a farmer could achieve significant tax savings by operating a profitable farm in a corporation. The savings arose because the farmer was taxed in an advantageous manner on dividends received from his corporation. Unfortunately, this form of saving has been substantially eliminated but there continues to be other tax advantages in certain situations.

When a corporation is set up a new "taxpayer" is created. The corporation has to calculate its income for tax purposes, file a corporate tax return (Form T2) each year and pay income tax at the appropriate rates.

The vast majority of family farm corporations in British Columbia are subject to a flat corporate income tax rate of 23% on their taxable income from farming operations in B.C. Such a company could have as much as $200,000 a year in taxable income, all taxed at a rate of 23%. Business income in excess of this level is generally taxed at a rate of 52%.* Over the lifetime of the company (or associated group of companies, if there is more than one) as much as $1,000,000 of business earnings can be accumulated at a tax rate of 23%.

Commencing in 1983, farm corporations will have to pay a tax on the dividends paid to their shareholder's, to the extent that those dividends come out of profits which have been taxed at the reduced corporate rate of 23%.** This new tax, which is often described as the "distribution tax" and is calculated as 12 1/2% of the dividends paid, is intended to remove the advantage that existed previously where farm income was earned through a corporation. This second level of tax effectively increases the corporate rate from 23% to 31%. Under the new system, a farmer who uses a corporation in British Columbia and distributes all of the company's after-tax income each year as a dividend will receive approximately the same amount as he would have done had he carried on his business as a proprietorship.

* Plus a surtax of approximately 2% in 1983 and 1% in 1984.

** This tax will not apply to dividends paid out of profits accumulated in years commencing before 1982. For the purposes of this new tax, profits accumulated in years commencing after 1982 are treated as being distributed before the profits of earlier years.

If the corporation carries on certain types of professional, service or management businesses at any time in the year (defined in the Income Tax Act as "non-qualifying businesses") the tax rate applying to the income from these businesses and to the income from the farming business for that year will be approximately 39%. The "distribution tax" (see above) will not apply to dividends paid out of this income.

Interest, net rental income and net taxable capital gains are taxed at 52% but there is a refund of approximately one-third of this tax when appropriate dividends are paid to the company's shareholders. Again, this rate is subject to the surtax in 1983 and 1984.

A special, fully refundable tax of 25% applies to dividends received from another corporation. There are certain exceptions, however, if the receiving corporation owns a significant number of shares in the paying corporation.

When an individual shareholder receives a taxable dividend from a Canadian corporation special rules apply which enable him to deduct a tax credit in respect of the tax that has already been paid by the corporation. The following illustration shows how the system works:

Cash amount of dividend, say	$ 1,000
Add: 1/2 gross-up amount	500
Taxable amount	1,500
Federal income tax (assuming a marginal rate of 30%)	450
Less: Federal dividend tax credit (34% of actual dividend)	340
Basic federal income tax	110
B.C. Income tax (44% of basic federal income tax)	48
Total income tax on dividend	$ 158

As mentioned earlier, if a farmer carries on his farming business through a corporation and distributes all of the after-tax income as a dividend, the total of the company tax (including the new distribution tax) and the shareholder tax will be approximately equal to the tax that he would have paid if he had carried on the business personally. This assumes that all the farming income is taxed in the company at the low rate of 23% and not at the higher rates of 39% or 52%.

Even though some of the tax savings have been eliminated, a farm corporation still offers the farmer the possibility of deferring tax if the farm generates more income than the farmer needs to live on. As mentioned previously shareholders are subject to tax on the dividends they receive and, in addition, there is the new "distribution tax" payable by the company. However, these taxes are payable only if the company pays dividends, and the owners of the company have complete discretion as to when this occurs. It is not unusual for a company to withhold the payment of dividends for many years, with the result that income tax on the potential dividend is postponed as well.

A corporation also continues to offer the farmer the possibility of avoiding tax through "income-splitting". While such splitting of income (spreading income around among family members) may be possible by means of family farm partnerships, the use of a corporation will generally provide the greatest opportunities of all in this regard.

To summarize, the introduction of the new "distribution tax" has eliminated much of the tax savings that have been available in the past. There continues to be ability to split income with members of the family and to defer tax but in most situations this advantage will not by itself, be sufficient to justify the incorporation of a farm.

In the past, many farmers were incorporated solely on the basis of the potential tax savings provided the impact of the "non-tax" factors was essentially neutral. In the future, this will occur to a far lesser extent because on a relative basis, the "non-tax" factors will be considerably more important.

5. Transferring Farming Assets and Operations to a Corporation

Question:

Can I incorporate my existing farming business (a proprietorship or partnership) without having to pay any income tax on the capital gain on my land and buildings or tax on the recapture of capital cost allowance on my machinery and equipment, or the gain on my livestock inventory or my quota rights? Some of these amounts are quite large and will give rise to a lot of tax someday. Will B.C. sales tax apply on the transfer of any of these assets to the corporation?

Answer:

In almost all cases the incorporation of the family farm can be accomplished without any immediate income tax cost arising. Special rules exist in the Income Tax Act which will permit all types of property (with certain specific exceptions which normally do not apply to farmers) to be transferred to the new company with no immediate tax cost arising. Certain tax forms must be filed and legal requirements met to take advantage of these rules. As long as the shares of the family farm corporation stay within the family and the corporation uses substantially all of its assets in its farming business then an indefinite deferral of income tax on these amounts may be available.

The B.C. sales tax, which might otherwise apply to certain types of assets, can generally be avoided at the time of incorporation due to specific exemptions which exist for assets used in a farming business (there is a specific list of such items in the B.C. sales tax regulations). There are also some additional exemptions from sales tax which may apply at the time a new company is incorporated with respect to property transferred to the company at that time.

6. "Cash" Method Reporting for Tax Purposes

Question:

I have always used the "cash" method for reporting my farm income on my tax return. I find that it gives me a lot of ways to keep my taxable income to a minimum. Don't I lose that advantage if my farm is incorporated?

Answer:

No. A farm corporation can use the cash method of reporting its farming income in the same way as any individual farmer. The Income Tax Act specifically allows any taxpayer, including a corporation, to elect to use the cash method in reporting income from a farming business. Virtually all of the other income tax rules that apply for an unincorporated farm business will apply to a farm corporation as well. The two major exceptions are that the five-year "block averaging" and the new "forward averaging" can be used only by unincorporated farmers, not farm corporations.

In the year that the farm corporation is set up, provided careful financial and tax planning is carried out, some very significant tax deferrals can be achieved. The termination of the farm operations carried on by the farm manager personally (or through a partnership) and the commencement of the farm operations by the corporation must be planned properly if other tax problems are to be avoided, however.

7. Ownership of Farmland and Buildings

Question:

Will I be better off having my farmland and buildings owned by the corporation or should I continue to own them in my personal name? Specifically, could I operate the farm with a corporation and just rent the land and buildings to the company? (I have a friend who put his farm into a corporation who is now sorry that he did so.)

Answer:

This is an extremely important question for many farmers. Ownership of land can be a very personal and emotional matter. The money that most farm managers have tied up in their farmland constitutes the bulk of their capital in many cases. It may represent their "pension plan" in a very practical sense.

In assessing this matter, farmers should be aware that the income tax rules which permit the transfer of family farms from one generation to the next also apply to the shares of family farm corporations. So if a farmer transfers land and buildings to a corporation carrying on his farming business he will not lose the ability to transfer his farm to his children on a tax-deferred basis.

Some people may argue that tax rules can always be changed and that at some point in the future it may not be possible to transfer shares in a family farm corporation to the next generation on a tax-deferred basis. This is so, but having granted this concession to farmers it would be surprising if any federal government would remove it or would treat shares of farm corporations any differently than farm property.

Farmers who continue to hold their farmland personally and provide it free of charge or rent it to their corporation (for cash or a share of the crop), may encounter serious tax problems. First, this property will not be eligible for the tax-deferred rollover which is normally available when farming property passes to the next generation. This problem arises because of the technical wording of the income tax law on this matter. Second, if the farmer trades his farm for another one, he will not be able to take advantage of the rules in the Income Tax Act which allow him to defer tax arising from the sale of his land and buildings. Third, the depreciation that may be claimed on the farm buildings for tax purposes is reduced by one half.

8. Principal Residence

Question:

At present, I can get a tax-free capital gain on my home and at least 1/2 hectare of my land since this is my "principal residence" for income tax purposes. How will the status of my home be affected as a result of the incorporation of the farming operation?

Answer:

Because of the advantageous income tax treatment of the capital gain on a person's "principal residence", it is usually desirable to retain ownership of the farm home in the farmer's personal name. This advantage is most easily obtained where the farm home is located on a parcel of real estate which is separate from the land on which the bulk of the farming operations are carried on. In many situations, of course, this will not be the case. Furthermore, an attempt to sever the parcel of land on which the home is located may be blocked by the restrictions imposed in B.C. by the Agricultural Land Reserve ("ALR"). Each farmer's circumstances will be different with regard to this matter and careful planning steps should be looked into before any property is transferred to a corporation. As a general rule, an effort should be made to retain personal ownership of the family home, if at all possible.

In the event that it is more convenient for various reasons to have the farm home owned by the corporation, then care must be taken to ensure that a reasonable rent is charged to the farmer and his family for their use of the home. If these arrangements are made then the farm corporation would be able to deduct all of the operating costs of the home as well as claiming capital cost allowance on it (within limits). The rent paid to the farm corporation by the farmer and his family (which could be made by a bookkeeping entry on a once-a-year basis) would be rental income of the corporation.

9. Transferability of Assets

Question:

Will the shares of a family farm corporation be transferable to my spouse, children, grandchildren, or other family members? Will it make any difference whether I transfer some of the shares now or do this some time in the future?

Answer:

The use of a corporation will provide many advantages concerning the transferability of ownership of the family farm. Shares could be transferred either shortly after incorporation or at any time in the future to a spouse, children, grandchildren, or even great-grandchildren with no serious tax consequences provided the guidelines in the Income Tax Act are met. The same privilege will exist at the time of the farmer's death if shares of the family farm corporation are passed on under the terms of his will. If the farmer happens to die without a will, the rollover privilege may still be available in many cases. To qualify for tax deferral under these rules, the farming business of the company must be carried on in Canada and substantially all of the property of the company must be used in the farming operation. The farmer, his spouse or children must also be actively engaged in the business.

The number of shareholders in the corporation could be as few as one (British Columbia permits a "one man corporation") or as many as desired. Even though a corporation could also be set up under the Federal laws (the Canada Business Corporations Act) most farmers would use the B.C. Companies Act to incorporate.

Transferability of ownership is a distinct advantage of a farm corporation over an unincorporated farm. Shares can be transferred easily with a minimum of cost and complications. Transferring ownership of a portion of an unincorporated farm, on the other hand, necessitates considerably more cost, complications, and careful tax planning.

10. Permanence of Business Operations

Question:

What happens to the family farm corporation in the event of my death? Does the company have to be dissolved if there is no one who can carry on operating the farm?

Answer:

No. The use of the corporate form of business organization can provide permanence and continuity for the farming operations. As long as the shareholders of the company desire, the company can continue in existence indefinitely. If the owner-manager of the company dies, then someone else would naturally have to take his place in managing the farm. The corporation would continue unaffected. It is an important advantage of incorporation that a particular farm unit can be preserved intact even though ownership of the business (in the form of shares of the company) may pass from one person to another or be divided among several family members.

It is not uncommon for corporations to carry insurance on the lives of its key employees. Such insurance money could help the farming corporation tide itself over at the time that the owner-manager dies and someone else has to be hired to run the farming operations. The cost of this insurance would not normally be a deductible expense for tax purposes.

11. Financing Capability

Question:

Will the use of a corporation affect my borrowing capacity? Specifically, will it make it easier or more difficult for me to obtain the financing I need to carry on my farming business?

Answer:

There may be specific situations where the use of a corporation will be required by certain lending institutions before they will give a farm manager the particular type of financing that he needs. An example would be a bank which wishes to secure its loan position by means of a floating charge debenture. The bank sometimes insists that the farmer be incorporated so that their security could be structured in this fashion. As we have indicated, however, no farmer should be forced into incorporation without a thorough consideration of all of the implications of such a decision.

The ability to attract capital and pool resources with others may be enhanced by means of a corporation as well. A broader range of investors may be attracted to financing a farm corporation as opposed to providing assistance to an unincorporated farm manager.

Care must be taken, however, in reviewing the specific guidelines for various sources of farm credit. There may be instances where a corporation may be subject to certain limitations that do not apply in the same way to individual or unincorporated farm managers.

As a general rule, the corporate form of organization will not inhibit a farmers financing capacity and may assist him to obtain certain types of loans. In many cases, of course, a farm manager will be required to personally guarantee the debts and obligations of the farm corporation.

12. Limited Liability

Question:

Of what advantage to me is the "limited liability" feature of a corporation?

Answer:

For many farmers (and many small business operators in general) the limited liability aspect of a corporation is not one of the significant factors in the decision to incorporate. It has been mentioned already that where outside financing is required the shareholder of the corporation will more often than not be required to given his personal guarantee to the lending institution. The effect of giving personal guarantees, of course, is that the assets that you own in your personal name are exposed to the same financial risks as the assets that are owned by the corporation.

Various forms of liability insurance may be available to protect the farm manager from different kinds of risks that may arise through the conduct of his farming operations. Such liability insurance coverage would be available whether or not the farm was incorporated. In summary, there will not be many farm managers who incorporate primarily because of the limited liability privilege.

13. Accounting Records and Legal Requirements

Question:

Will the use of a corporation make my accounting records a lot more complicated? Do I have to prepare a lot of reports and file additional tax returns that I could avoid by not using a corporation? What sort of legal records have to be kept for the company?

Answer:

There is no denying that the record keeping and financial reporting requirements for a corporation are more extensive and stringent than those which apply to an unincorporated farmer. But they may not be as bad as they are rumored to be. If you presently use an accountant in the preparation of your personal income tax return, then he will more than likely be quite familiar with the reporting requirements for your

farm corporation as well. As a matter of fact, if he is a public accountant with a variety of different clients, he will likely spend most of his time working on corporations rather than unincorporated businesses.

Farmers who incorporate will be required to have a tax return prepared for the company and the financial information that will have to be filed with this return will be more extensive than that prepared for most partnerships or proprietorships. After incorporation, the farmer's individual tax return will be easier to prepare, however, because he will have to account only for salaries and dividends received from his corporation and any other incomes or deductions that he might have.

The legal requirements for a farm corporation are relatively uncomplicated once the company has been established. You will normally require the services of a lawyer to maintain a "records office" for the company. This is a routine function for most law offices, and does not involve a substantial cost.

14. Separation of Personal Transactions from Farm Business Transactions

Question:

Right now some of my personal expenses and non-farm income are mixed in with my farm business dealings. My accountant sorts it all out at the end of the year and keeps me honest with the Income Tax Office. Can I continue on the same basis if I use a corporation?

Answer:

Generally, the answer to that question might be yes, although incorporated farmers should avoid this from happening if they possibly can. Even though it is most desirable to maintain a complete separation of personal financial transactions from those of the farm corporation, it may sometimes happen that the corporation will pay expenses of a personal nature for the farm manager and his family. Likewise, the farm manager may incur costs out of his own pocket which are really related to the farming operation. In either case these details can be sorted out on a once a year basis if desired. Most out-of-pocket costs incurred by the farm manager himself, which are incurred in connection with the business of the farm corporation, could be credited to shareholder's advance account and deducted as expenses of the company. On the other hand, costs incurred by the farm corporation which were of a personal nature for the benefit of the farm manager or others should be charged against the shareholder's advance account or repaid by the individual in question.

Special care must be taken to ensure that the income tax guidelines on these matters are followed. It would be wise to set up the ground rules on this matter with your accountant at the time the corporation is established.

15. Family Participation

Question:

How would a corporation allow other members of my family (spouse, children, etc.) to participate in the farming business?

Answer:

A corporation permits a great degree of flexibility in the way that family members can participate in a farm business. Anyone who provides services to the company can be an employee and can be paid a wage for services provided. (There is no minimum age for an employee, although putting your one-and-a-half year old son on the payroll could raise some questions!) While amounts paid to employees must be reasonable in the light of the work that they do, considerable leeway exists for setting salary or wages at levels which are advantageous in the overall financial and tax planning for the farm business.

Family members can also be shareholders in the company and may receive dividends on shares that they own. The same person could be both a shareholder and an employee.

A carefully planned family farm corporation will be tailored to the exact needs of the particular family involved. Flexibility can be maintained so that changes can be made in the light of changing circumstances for the family.

In summary, the family farm corporation will provide significant financial and tax advantages by allowing the whole family to take part in the business. Substantial income tax savings can be realized through the "splitting of income" which arises as a result of arrangements of this type.

16. Fringe Benefits and Deferred Income Plans

Question:

How will Canada Pension Plan coverage and contributions to RRSP's deferred profit sharing plans, etc. tie in to the use of a family farm corporation?

Answer:

Canada Pension Plan coverage will be available much in the same way as it is for an unincorporated farmer except that the cost of coverage will now be shared equally between the corporation itself and the shareholder-employee who operates the farm. Additional Canada Pension Plan entitlements can be built up for the farmer's wife by paying her a salary out of the farm corporation. The spouse's salary is subject to the same Canada Pension Plan contributions as the farm manager.

The use of RRSP's will depend on the level of salary which the farm manager or other employees draw from the corporation. In the past, a farmer who incorporated his farm could consider setting up a deferred profit sharing plan in the corporation so that amounts could be deducted from the corporation's taxable income and set aside for the farmer's retirement. This is no longer possible. These plans may now only be used for employees not related to the farmer.

17. Selling Out

Question:

Suppose I want to retire and decide to sell the farm "lock, stock and barrel" to an unrelated third party? Will ownership of the farm in a corporation be an advantage or a disadvantage, if and when that time comes?

Answer:

The sale of a family farm (whether it is owned in the farmer's personal name or through a family farm corporation) to a third party will mean that many of the tax deferral privileges he has enjoyed will come to an end. Capital gains, recaptured capital cost allowance, proceeds from cash basis inventory, etc. will have to be dealt with at that time.

In 1981 and previous years individual farmers could defer taxes arising on the sale of their farms by purchasing income-averaging annuity contracts (IAAC's). They could also reduce tax under the general averaging rules in the Income Tax Act. Unfortunately, this is no longer possible under the current tax rules.

The answer to the question of whether the tax implications would be more severe for a family farm corporation or an unincorporated farm will depend on the circumstances of the particular situation and the manner in which the sale agreement is drawn up. In some situations a farm corporation will be advantageous because it will give the farmer the opportunity of selling shares of his company rather than having the company sell its individual assets. Structuring the sale in this manner simplifies the transaction and may enable the farmer to save tax. Another advantage of a farm corporation is that it may permit the deferral of tax on income arising from the sale of livestock and quota and on recaptured depreciation. This type of income, together with operating profits in the year of sale, up to a maximum of $200,000, will be taxed at a rate of only 23% whereas if the income had been realized by an individual farmer it may have been taxed at much higher rates. It is true that there will be a further tax when the corporation distributes its income to its shareholders but this tax will be deferred until the actual distribution is made.

Depending on the circumstances, operating the farm as a proprietorship or partnership can be advantageous too. It will enable the farmer to claim the principal residence exemption on his house and 1/2 hectare, he can use forward averaging or block averaging and, if he is a sole

proprietor and has a non-calendar year-end, he may be able to reduce tax by structuring the sale so that his capital gains are taxed in one year and his recaptured depreciation and his income from the sale of quota and livestock is taxed in the next.

It is unfortunate that the question of whether or not a farm corporation will result in additional tax on the sale of the farm cannot be answered with a simple yes or no. What can be said, however, is that as a general rule the fact that a farm business is owned by a corporation should not seriously impair the ability of a farm manager to sell out to a third party. It should also not result in significant increased taxes provided that the sale of assets and the subsequent winding-up of the corporation is structured properly. In some circumstances, a farm corporation may even improve the farmer's position.

It should also be noted that if a farm manager gives up one operation (such as a cattle ranch near Kamloops) and moves to a new location to undertake another type of farming business (such as a dairy farm in the Fraser Valley) income tax rules may be available to permit a deferral of capital gain and recapture of capital cost allowance on the original property as a result of the purchase of the "replacement" property. Certain guidelines in the Income Tax Act have to be met. The main point to note is that the "rollover" privilege for moving a farming business is available to a farm corporation as well as to an unincorporated individual farmer.

The most important point to be noted here is that whether the farm is operated as a proprietorship, partnership or in a corporation there is not a great deal that can be done <u>after a sale</u> to minimize the farmer's taxes. This is particularly true now that IAAC's are no longer available and farmers are less able to claim reserves in respect of the unpaid proceeds from the sale of their assets. Consequently, farmers should be asking their advisers for advice <u>before</u> the sale takes place; preferably a <u>long time before</u>.

18. Your Will and Your Estate Plan

Question:

According to the terms of my will I leave everything to my wife (if she happens to live longer than I do). If I outlive her, then everything I own will be divided equally among my five children. The family farm is a special problem in this regard because two of my children want to stay in the farming business while the other three are pursuing their education and careers off the farm. My wife and I want to treat all of our children as fairly as possible to avoid hard feelings. Will the use of a corporation make it easier or more difficult to ensure that there is an equitable sharing of our estates when we die?

Answer:

As has already been discussed, a particular advantage of the corporate form of organization is the unique ability to share the ownership of a farming business while maintaining the farm itself as an indivisible economic unit. A common way to handle the situation where some children are going to continue in farming and others are not, is to anticipate this problem by means of a carefully prepared shareholders' agreement. The children who are eventually destined to take over the operation of the farm could be provided with a means to buy out the shares of those children who are pursuing careers elsewhere. Alternatively, the shares of those children could be redeemed by the company at their fair market value.

The advantages of the foregoing arrangement are twofold. It would ensure that the ownership of the farm passes to those children who are able and interested to continue it; it would also ensure that the children who are living off the farm receive fair value for their part of the family inheritance.

The use of a corporation in detailed estate planning of this kind can be extremely advantageous.

19. Changing Your Mind

Question:

Once I have incorporated the farm, what happens if I later want to change my mind, or, if for some other reason the company has to be dissolved and the assets taken back out into my personal name? Can this be done? What are the implications?

Answer:

To "undo" a corporation that is owned by individual shareholders will often result in some substantial income tax costs. This is due to the fact that when a corporation is dissolved and wound up, its debts paid off and its property distributed to its individual shareholders, most income tax liabilities that may have been deferred until that point in time have to be faced. (A corporation that is a wholly-owned subsidiary of another corporation, on the other hand, can usually be wound up with a deferral of most potential income tax costs.) Once a farmer's assets have been transferred into corporate ownership then it is extremely difficult to move them back out into personal ownership without a tax cost arising. A variety of different planning opportunities may be available which permit reorganization of corporations and transfers of assets from one corporation to another, or into a partnership, however.

Any situation which requires a corporate liquidation should be discussed with professional advisors who are competent to deal with both the legal and income tax implications of this event.

For this reason alone, the use of a corporation to own and operate a farm is a step which must be considered very thoroughly before irreversible action is taken.

In other words, don't incorporate your farm business unless you are quite sure that you are making the right decision for the long-term.

20. Additional Costs

Question:

I know that all of these good things that a corporation will supposedly do for my farming business are going to cost me money. How much should I expect to have to pay my lawyer and my accountant?

Answer:

The legal fees required for setting up a corporation are normally in the range of $700 to $800 (including disbursements) in a straight-forward situation. Additional legal costs and filing fees can be expected with respect to the transfer of specific assets from a farmer's individual name into corporate ownership. The cost of maintaining a "records office" for the company as well as the filing of the annual report with the Registrar of Companies in Victoria and other routine legal matters may cost approximately $150 a year to the corporation. These recurring legal fees would be deductible for income tax purposes. The legal costs incurred at the time of incorporation would normally have to be capitalized.

Accounting fees incurred in connection with the set-up of the corporation will generally be determined based on the amount of time that your accountant has to spend in preparing a financial and tax planning strategy for you and your company. Part of this work will require detailed calculations with respect to the various assets being transferred to the company, discussion with the lawyer and yourselves as to the exact share structure of the company and the issuance of shares to various family members, preparation of special tax forms that must be filed to ensure that the transfer does not give rise to income tax, and other matters related to the corporation. Hourly rates charged by qualified accountants who specialize in this type of work may range from about $50 an hour to $150 an hour (or more) depending on the level of their expertise and their seniority within their particular professional firms.

There is another expense item that should not be overlooked. In many cases appraisals will be needed to establish either V-day values or current fair market values (or both) for the farm assets. It is absolutely essential that all of this data be available at the time that assets are being transferred to a corporation. While estimates may be used in many cases, the farmer's income tax position is always strongest if he can support his figures with appraisals that have been prepared by qualified experts in this field.

Two comments should be made with regard to the costs of obtaining professional advice. You get what you pay for. Good advice is going to be expensive; poor advice will likely come cheap.

Before a farm manager embarks on incorporation of his business he should be very sure that the benefits are going to justify the costs which will be incurred. Don't incorporate unless the costs of doing so will clearly pay for themselves in a short period of time. Most professional accounting and legal advisors should be able to help you make this judgement and should be willing to provide you with reasonably accurate estimates of their costs.

PART II

HOW TO GO ABOUT INCORPORATING THE FAMILY FARM

If a farm manager makes a decision that the use of a corporation would be advantageous to him, his next problem is to find out how he should go about setting up a company. In the following series of steps we have made some suggestions as to how this might be done most effectively.

1. Talk to Others Who Have Incorporated Their Farms

If you know friends or neighbours who have incorporated their farms, it would be useful to talk to them about the various ways in which the use of a corporation has been advantageous (or detrimental) to the conduct of their farming businesses. Make note of any special problems or unexpected costs that they may have encountered so that you can review these particular items with your own advisors beforehand.

2. Contact Your Regional Farm Economist

Before you take any steps yourself, you might want to review the details of your own farming operation with a representative from the B.C. Ministry of Agriculture and Food in your area. He will undoubtedly have experience with various other farmers who have incorporated and will likely be able to offer further guidance and practical advice with regard to your own situation. Once again, you should compile a checklist of any particular items (such as the transfer of quota rights, for example) which may require some special attention at the time of your incorporation. The continued availability of various government subsidies, interest rebates, etc. that your farm might be receiving should be discussed as well. It's very important that none of these forms of financial assistance be jeopardized as a result of the incorporation.

3. Obtain Competent Accounting Advice

Having done your homework this far, the next step is to contact your accountant. He can advise you as to the timing of the incorporation that is best in your particular situation. He will also take responsibility for the details required for various tax calculations and financial statements, assist in the valuation of the farm assets and generally provide the overall guidance that you need to set up the company.

If your own accountant is not experienced in this particular field (or if he is too busy to give you the attention that you need) urge him to refer you to someone else who can help you in this matter. Like doctors, some accountants are "general practitioners" and may not want to undertake specialized or complicated reorganizations. You should always determine in advance whether your own accountant is able and willing to do what will be necessary for you to establish your corporation properly.

The important point is to get the best advice you can for your money.

Your day-to-day bookkeeping and accounting requirements, and your year-end financial statements and tax return are possibly being handled at the present time by your regular accountant at a very reasonable cost. This situation could continue once the corporation is set up and operating. It is only for those special situations such as the transfer of assets to the corporation, the development of the overall tax and financial planning strategy, etc. that you may wish to seek specialized advice. A tax specialist will undoubtedly charge you considerably more for his time (on an hourly rate basis) but he will likely not want to do your day to day bookkeeping or accounting work. Instead, he will simply advise you, based on all of the facts and on your personal financial goals, as to how to develop a plan for the establishment and ongoing operation of the farming business. This should be coordinated with your estate planning, the wishes expressed in your will, your insurance needs, your retirement planning, and any other major aspects of your personal financial situation.

4. Select a Lawyer

A recommendation as to a lawyer to use for the incorporation of the company and for the other legal documents required with regard to the transfer of assets, etc. will often come from your accountant. He will likely know a number of lawyers and be able to advise you as to a particular one who is suited to your needs. If there is a "family lawyer" who has done work for you and your family in the past, of course, then he would be the one to approach directly in this matter.

We have suggested that the initial contact with a professional advisor be your accountant who would then recommend a lawyer to you. Sometimes this may happen the other way around. You might contact your lawyer initially and he might then recommend to you an accountant who was particularly qualified in this type of work. Much will depend on the people that you already know in your community who practice accounting or law.

5. The Size of Your Community May Limit The Professional Services Available

It may often happen that there is no one available in your community to provide the services that you require to do a proper job of incorporating your farming business. We feel very strongly that it is always best to use someone in your own community (or the closest urban centre) if you possibly can for all of the work that you require. This approach has an advantage in that people who are close to home will be available to provide follow-up work or advise on new developments or changes in your plans. Continuity in professional services is sometimes a problem, but it is minimized in small communities where professionals are generally less mobile.

Generally, it is preferable to deal with a medium-sized firm of lawyers and accountants which can provide the continuity of personnel. If the accounting firm has a tax specialist as well as general practitioners it will be able to handle the incorporation of the farm and deal with the

ongoing accounting matters for the corporation. If the farmer deals with a larger firm the level of specialized knowledge will be satisfactory but the quality of personal service may suffer a little bit. If he deals with a sole practitioner or a small firm then the level of personal service may be good but the level of specialized knowledge may be uncertain. If the particular community in which you live does not have persons qualified, in your opinion, to handle your situation adequately, then you might want to seek help elsewhere through recommendations made by others. Representatives from the Farm Economics Branch may be able to assist in this regard. You could also contact the professional associations of the lawyers and accountants in B.C. for the names of lawyers and accountants best suited to your needs.

6. Information that will be Required by Your Accountant and Lawyer for the Incorporation of Your Farming Business

What do you take to your accountant or lawyer? (No matter how well you prepare yourself, you can rest assured that he will ask you for something you didn't bring!) Here is a checklist of some of the main items to assemble.

a) A sketch of the physical layout of the farm showing the different parcels of land, location of buildings, the farm home, etc. Photographs might also be useful.

b) If the farm was owned at December 31, 1971 (or owned by a parent as of that date) then it is necessary to have a complete listing of all of the farm's assets owned at that time together with an estimate of their fair market value as at December 31, 1971. This information is extremely important for the incorporation of any family farm that was owned and operated by the farmer or anyone else in his family at December 31, 1971.

c) A summary of your estimates of the fair market value of all of the farming assets on hand at the present time (in as much detail as you can provide) is essential. This doesn't necessarily have to be done by an independent appraiser, although the fact that your values are agreed to by a qualified third party is always useful in case of future disputes with Revenue Canada.

d) Your personal tax returns and farming financial statements for as many previous years as you have them on hand would be useful. If you have a budget projection for the current or future years this would be important supplementary information for your accountant as well.

e) You should choose at least three different names that might be used for the farming company. Your lawyer will check with the Registrar of Companies in Victoria to see whether your first choice of a name is available. If it is, then he will "reserve" the use of that name for a period of time until the corporation is set up. You will not be allowed to use a name which either is the same as the name of an existing company in B.C. or is considered to resemble an existing

corporate name too closely. That is why it is always wise to have a couple of "second choices" in mind in the event that the name that you prefer is not available to you.

f) You should also have a reasonably good summary of your personal financial goals as well as those of other members of your family who may be participating in the farming operation. A key item would be the cash flow that you require per month in order to meet your living costs, when you expect that you would want to retire, the likelihood of the farm staying in the family or being sold to an outsider, etc. All of these things are useful information to your accountant and lawyer in the way in which they structure the corporation and help you plan your future financial and tax strategies.

g) You should have given some very careful thought as to how the ownership of the company is to be arranged. Your lawyer and accountant will help with the details of the various kinds of shares that are to be authorized but they will look to you for guidance concerning the number of shares to be issued, and to whom.

7. How Long Does it Take to Get Incorporated?

A company can sometimes be set up and accepted by the Registrar of Companies in Victoria within a period as short as 24 to 48 hours if a "rush job" is needed. Normally a farmer should allow a period of 1 to 2 weeks (at least) for the company to be created once the details of the corporate structure have been finalized with the lawyer and the documents sent off to Victoria.

8. Do I Really Need a Lawyer or an Accountant? Can't I Do All of This Work Myself and Save the High Cost of Obtaining Professional Advice?

Answer:

In most situations - No.

Should I Do It All Myself?

Answer:

Only if you have the knowledge, ability, and time to carry out the work properly. Keep this important analogy in mind. The vast majority of lawyers and accountants would not be able to operate a farm or a ranch very well on their own. They would require expertise from someone who knew what they were doing and who had previous experience in farming or ranching. The same is probably true of most farm managers who attempt to incorporate themselves. Yes, they can do it but no, they should not do it (in the majority of cases).

It is always wise, however, to learn as much about the operation of a corporation as possible if that is the form of business organization that you are going to use. Don't be afraid to ask a lot of questions of your

lawyer and accountant on matters which may seem very basic. The use of a good "self help" booklet on corporations (there are a number of these types of publications available) would be advisable as well to give you some background into the details of the legal requirements and the legal forms, etc.

9. **What Administrative Matters Have to be Dealt With When a Business is Incorporated?**

This will depend on the farmer's particular circumstances. However, the appendix attached to this publication sets out certain basic matters that generally will have to be dealt with on all incorporations.

INCORPORATION OF A BUSINESS **APPENDIX 1**

ADMINISTRATIVE MATTERS

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1. Obtain an appraisal of the land, buildings, equipment, vehicles, quota and livestock being transferred to the corporation.

2. Determine what value, if any, should be placed on the goodwill associated with the business.

3. Find your tax returns for the last few years in which you have carried on the business - your accountant may need them.

4. Discuss with your accountant and consider carefully the nature of the shares to be issued by the new corporation.

5. Discuss with your accountant or solicitor whether all of the debts of your unincorporated business can be transferred to the corporation.

6. Determine whether the transfer of your business requires <u>advance</u> approval from any person (e.g. Milk Quota is transferable only on the first of a month and the Milk Board normally requires one month's notice of the proposed transfer).

7. As at the close of business on the day immediately prior to the day on which the assets are to be transferred to the corporation, prepare a summary of the following:

   - cost of inventory (fair market value of farm inventory) on hand;
   - the face value and estimated collectible value of the accounts receivable to be transferred to the corporation;
   - accounts payable to be assumed by the corporation; and
   - bank debts, mortgages, etc. to be assumed by the corporation.

8. Administrative matters: -

- advise bank, suppliers and other persons who deal with the partnership/proprietorship that the business will be carried on by the new corporation;

- open a new bank account, and arrange for new cheques to be printed in the name of the company. Use this account from the date the corporation commences to carry on the business;

- open new accounting records from the date the corporation commences to carry on the business;

- obtain an employer tax number for the new corporation from Revenue Canada;

- obtain a sales tax number from the Minister of Finance in B.C. in the name of the new company;

- advise trade associations;

- register vehicles in the name of the company on or shortly after the date on which the company acquires title thereto;

- enquire whether a new business licence is required;

- amend lease arrangements;

- arrange for insurance coverage to be transferred to the corporation or take out new policies; and

- obtain new stationery.

APPENDIX 2

1983 FEDERAL BUDGET PROPOSALS OF PARTICULAR INTEREST TO FARMERS

On April 19, 1983, the federal government tabled its 1983 budget in the House of Commons. This budget came on the heels of the enactment of the November 12, 1981 and June 30, 1982 federal budgets which, after considerable delay, were passed into law on March 30, 1983.

Summarized below are the proposals in this budget which are of particular interest to farmers. It should be noted that they are not yet law and could be amended by parliament.

1. The Income Tax Act (the Act) now permits a farmer to transfer shares in a farming corporation to his children on a "rollover basis". These rules are discussed in chapters 13 and 14. The government now proposes that the rules be broadened so that a "rollover" can be obtained on the transfer of shares of a family farm holding corporation. This change is to be made effective for transfers after May 25, 1978, which is the date on which the farm corporation rollover rules were put into the Act.

2. The government has proposed that the loss carry-over rules be liberalized. Under these proposals, the farm losses of an individual, partnership or corporation (including restricted farm losses - see chapter 12) may be carried back three years instead of one, and carried forward for ten years instead of five. In most situations, these new rules will apply to losses for the 1983 and subsequent taxation years.

   The rules dealing with the carry back of net capital losses are to be changed also. It is proposed that net capital losses incurred in 1984 may be claimed against net capital gains earned in the 1982 and 1983 taxation years. Net capital losses incurred in 1985 and subsequent years may be carried back three years. Individuals who incur capital losses in 1984 may apply up to $2,000 of the allowable loss against any income earned in 1982, 1983 and 1984. At present, net capital losses may be carried back only one year.

   Rules are to be introduced that will restrict the deduction of farm losses by a corporation where there is a change in control.

3. The government has proposed a number of changes to the investment tax credit rules (see chapter 8). The highlights of these changes are as follows:

   - Credits arising from eligible investments made after April 19, 1983 may be applied against federal taxes payable without regard to the limits that apply currently (see page 38). The carry-forward period for these credits is to be increased from five years to seven years.

- Credits earned after April 19, 1983 may be carried back for three years to reduce federal tax in those years. This measure is to be phased in over the 1983 and 1984 taxation years.

- A portion of the credits earned on eligible investments made after April 19, 1983 and before May 1, 1986 will be refunded directly in cash to taxpayers who could not otherwise fully use their credit to reduce their federal tax. Individual farmers and farm corporations eligible for the low rate of tax will be able to obtain a cash refund in any particular year of 40% of the unused credits earned in that year.

- The government has proposed a novel concept under which corporations can use tax credits earned on the purchase of new assets to attract purchasers of new common share equity. Under this concept, corporations will be allowed to issue shares which will entitle the first purchaser to a tax credit of up to 25% of the issue price paid. Share purchase tax credits claimed by share purchasers will reduce the amount of the tax credits available to the corporation. Only credits earned after April 19, 1983 will be eligible to be transferred to purchasers of new shares. This proposal will probably not be of much interest to the average family farm.

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